ORIGINAL

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

RALPH R. UMSTED, JR., et al., on behalf of themselves and all others similarly situated,	§	
Plaintiffs,	§	
v.	§	Civil Action No. 3:02-CV-496-M
ANDERSEN LLP f/k/a ARTHUR ANDERSEN LLP,	§	
Defendant.	§	

MEMORANDUM ORDER AND OPINION

Before the Court is Defendant's Motion to Dismiss Plaintiffs' Class Action Complaint. On March 11, 2002, Plaintiffs Ralph Umsted, Jr., Diana Hall, Michael Monahan, and Richard White, Sr., purporting to act on behalf of themselves and others similarly situated, sued Arthur Andersen L.L.P. ("Andersen"), alleging securities fraud. Plaintiffs claim that Andersen misstated material facts in its audit report for the 1997 financial statements of Intelect Communications, Inc. ("Intelect"). On June 7, 2002, Andersen filed a Motion to Dismiss on two grounds. First, Andersen asserts that Plaintiffs' Complaint rests on documents that Plaintiffs improperly acquired and that violate the discovery stay provided by the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Second, Andersen asserts that Plaintiffs' Complaint fails to state a claim because Plaintiffs do not state with particularity facts supporting a "strong inference of scienter." In light of this Court's prior rulings, Andersen's Motion to Dismiss because of improper use of discovery materials is **DENIED**. For the reasons stated below, however, the Court **GRANTS** Andersen's Motion to Dismiss for

failure to properly plead scienter, but grants Plaintiffs a single thirty day opportunity to replead.

FACTUAL PREDICATE

In 1997, KPMG, Intelect's outside auditor, issued a going concern qualification to Intelect's 1996 financial statements because, *inter alia*, Intelect consistently lost money over the preceding years, totaling $51 million from 1993 to 1996. Shortly thereafter, Intelect terminated KPMG as its outside auditor, and retained Andersen as its new auditor. On March 27, 1998, Andersen issued its audit report on Intelect's 1997 financial statements. The report did not contain a going concern qualification, and did not expressly allude to financial troubles at Intelect. The report stated that Intelect's 1997 financial statement fairly presented the company's financial position, and that Andersen's audit conformed with generally accepted accounting principles ("GAAP"). On November 17, 1998, Intelect announced a $23 million net loss for the third quarter of 1998, as well as other negative news. These announcements preceded a dramatic drop in the price of Intelect's stock. Plaintiffs claim they would never have purchased Intelect stock at the high price they paid had Andersen properly audited and fully disclosed the true financial condition of Intelect.

ANALYTICAL FRAMEWORK AND STANDARD OF REVIEW

Federal Rule of Civil Procedure 12(b)(6) provides a basis for the dismissal of Plaintiffs' claims if the Complaint fails to state a claim upon which relief can be granted. However, a Rule 12(b)(6) dismissal, without leave to amend, should be granted only if the Plaintiffs can "prove no set of facts in support of [their] claims that would entitle [them] to relief."[1] At this stage of review, the Court must "accept all well-pleaded facts as true" and must view those facts "in the light most

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[1] *Conley v. Gibson*, 355 U.S. 41, 45-6 (1957).

favorable" to Plaintiffs.[2] Furthermore, "in the securities context, Rule 12(b)(6) dismissals are difficult to obtain because the cause of action deals primarily with fact-specific inquiries."[3]

To state a claim under section 10(b) of the Securities and Exchange Act and Rule 10b-5, a plaintiff must allege (1) a misstatement or omission, (2) of material fact, (3) made with scienter, (4) on which the plaintiff relied, (5) that proximately caused the plaintiff's injury.[4] The Complaint must also meet the strict pleading requirements for fraud which have developed under the PSLRA and under Federal Rule of Civil Procedure 9(b).[5] In particular, when pleading the element of scienter, a plaintiffs must "plead specific facts giving rise to a 'strong inference' of scienter."[6] A plaintiff can meet this "pleading obligation based on conscious behavior or severe recklessness of the defendant."[7] In this case, severe recklessness would mean Andersen misrepresented or omitted material facts in a manner considered an "extreme departure from the standard of ordinary care, and that [Andersen knew or must have known its acts] present[ed] a danger of misleading buyers or sellers" of the stock.[8] Furthermore, although motive and opportunity alone are insufficient, they can contribute to

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[2] *See generally, Capital Parks, Inc. v. Southeastern Advertising and Sales Systems, Inc.*, 30 F.3d 627, 629 (5th Cir. 1994).

[3] *Haack v. Max Internet Communications, Inc.*, 2000 U.S. Dist. LEXIS 5652 *11 (N.D. Tex. April 2, 2002) (Fish, J.) (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 240 (1988)).

[4] *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994).

[5] *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 430 (5th Cir. 2002).

[6] *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 407 (5th Cir. 2001).

[7] *Haack,* 2002 U.S. Dist 5652, at 19 (citing *Mortensen* v. *AmeriCredit Corp.*, 123 F. Supp. 2d 1018, 1023 (N.D. Tex.) (Fitzwater, J.) *aff'd*, 240 F.3d 1073 (5th Cir. 2000); *Krogman v. Sterritt*, 1999 WL 1455757, at *3 (N.D. Tex. July 21, 1999) (Maloney, J.).

[8] *Abrams*, 292 F.3d at 430.

a strong inference of scienter.[9] The Court must consider whether all of the facts alleged in the Complaint support a strong inference of scienter on the part of Andersen.

ANALYSIS

Andersen argues the Plaintiffs fail to plead sufficient specific facts to support a strong inference of scienter. Andersen asserts that the Complaint alleges nothing more than that Andersen violated professional standards in performing the Intelect audit and that those general violations led to the alleged fraud.[10]

Plaintiffs contend that the potential for significant fees, a chance to do lucrative consulting work for Intelect, and the opportunity to grow its presence in the Dallas auditing market motivated Andersen to take the Intelect account and ultimately to commit securities fraud.[11] The Complaint further asserts that when it issued its 1997 opinion, Andersen had already incurred fees of $335,000 and issued a clean opinion out of fear of not being paid. Andersen knew that Intelect's prior auditors, KPMG, had issued a going concern qualification to Intelect's 1996 financial report and the Complaint asserts that Andersen knew Intelect's management was excessively interested in increasing, or at least maintaining, its stock price and earnings trends, by using unusually aggressive accounting practices.

The four categories of alleged misconduct attributed to Andersen relate to (1) improper

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[9] *Nathenson*, 267 F.3d at 410-11 ("The most sensible approach appears to us to be [to] . . . decline[] to hold that allegations of motive and opportunity , "standing alone," meet the pleading requirement.") (internal citations omitted).

[10] The professional standards to which the parties point are GAAP and generally accepted auditing standards ("GAAS").

[11] Def.'s Mot. to Dismiss at 16-7.

recognition as revenue of contingent or consignment sales; (2) failure to properly accrue start-up and warranty costs; (3) improper capitalization of software development costs and (4) failure to write down inventory and goodwill. Andersen is also charged with failure to issue a going concern qualification.

Intelect is alleged to have improperly recognized $9.1 million in the last quarter of 1997 and $9.8 million for all of 1997 as revenue from shipments to Amerix, its Korean distributor. Amerix allegedly did not have the ability to pay Intelect until it resold the product in Korea and Plaintiffs contend that Amerix actually had the goods on consignment. Plaintiffs contend Andersen did not consider the failing Korean economy and declining value of Korean currency in evaluating Amerix's ability to pay, and that it did not undertake an independent inquiry into Amerix's ability to pay. Plaintiffs further allege that Andersen reviewed the draft financial statements of Opicom, Amerix's largest customer. Those financial statements allegedly put Andersen on notice that Opicom would not be able to pay Amerix until its customers paid Opicom, making Intelect's receivables from Amerix even more uncertain. Notes on an Andersen auditor's copy of a discussion agenda prepared for a meeting with Intelect's audit committee allegedly indicate that Andersen knew there was a problem with $1,000,000 in receivables from Amerix that warranted adjustment. The notes specifically say, "Full disclosure – If not collected by 5/15 – We're dead." Intelect declined to make a $1,000,000 adjustment, but Andersen took no further action about it.

Despite Andersen's recommendation, Intelect did not reserve as uncollectible $308,000 owed by Intelects' Argus Systems Group, Inc. and $266,256 owed by Rohde & Schwarz. Andersen is faulted for failing to insist that Intelect reverse $1.65 million in revenue it had recorded in December 1997 from MFS Network Technologies ("MFS"), when Intelect officers told Andersen that payment

from MFS would not actually arrive until sometime in 1998. Intelect is alleged to have failed to accrue at least $500,000 of start up and warranty costs on its SonetLynx systems shipped during 1997. The capitalization of SonetLynx and LANscape products is alleged to have far exceeded gross margin on the sales, so that their costs should have been expensed rather than capitalized. Inventory and good will from Intelect's S4 product for air traffic control was allegedly unrecoverable so that it should have been written off.

Plaintiffs allege that multiple Andersen documents indicate Andersen knew a great deal about the financial deficiencies at Intelect. Andersen initially characterized Intelect as a "high risk audit;" but Andersen failed to modify its audit procedures accordingly. Andersen performed a "New Client Background Investigation," and learned that the SEC had eighteen years before investigated Intelect's CEO, Herman Frietsch, for improprieties at another company which resulted in a consent decree. Andersen's "Approval Report" accepting the Intelect engagement included a warning that Andersen might also have to issue a going concern qualification on Intelect's 1997 financial statements.

The Court must decide if enough specificity exists in the Complaint to support a strong inference of scienter. The Fifth Circuit, in *Abrams v. Baker Hughes, Inc.*, recently explained that "mere publication of inaccurate accounting figures or failure to follow GAAP, without more, does not establish scienter."[12] That conclusion is the basic thrust of Andersen's Motion to Dismiss.

Even prior to *Baker Hughes* there was a judicial consensus that mere general allegations of

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[12] 292 F.3d 424, 432 (5th Cir. 2002)

violations of GAAP and/or GAAS are insufficient to state a claim for securities fraud.[13]

Andersen characterizes the contentions in the Complaint as mere allegations of alleged violations of GAAP and GAAS. Andersen then maintains that such pleading is nothing more than an attempt to convert negligence claims into securities fraud claims, without a sufficient basis to support a strong inference of scienter.

Plaintiffs counter that the magnitude of alleged violations and the specificity of facts pleaded, coupled with numerous "red flags," distinguish the instant Complaint from one that alleges only negligence claims and a failure to follow GAAP and/or GAAS.

Courts have not dismissed when plaintiffs have alleged "specific and detailed allegations about defendants' violation of GAAP, as well as other alleged misstatements, regarding the company's earnings and technical problems" [which] "when viewed in their entirety — support[ed the claim]."[14]

In *In re Ikon Office Solutions, Inc. Securities Litigation*, the Court found the plaintiff properly

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[13] In *Mortensen v. AmeriCredit Corporation, supra*, the Court granted a defendant's motion to dismiss, finding the plaintiff pleaded generally that AmeriCredit must have known its practices violated GAAP, but plaintiff did not provide specific factual allegations of actual violations of GAAP or contrary industry practice or contrary auditor advice. In *Zucker v. Sasaki*, 963 F. Supp. 301, 307 (S.D.N.Y. 1999), the Court granted a defendant's motion to dismiss where the plaintiff pleaded only that the defendant generally misapplied accounting principles and failed to write down accounts receivable of doubtful collectibility. In *In re K-Tel International, Incorporated Securities Litigation*, 300 F.3d 881, 891-94 (8th Cir. 2002), the Eighth Circuit affirmed a district court's dismissal of a case where plaintiff alleged generally that the defendant failed to properly dispose of long-lived assets and improperly accounted for losses. In *DSAM Global Value Fund v. Altris Software, Incorporated*, 288 F.3d 385, 390 (9th Cir. 2002), the Ninth Circuit affirmed dismissal because plaintiff alleged only that the auditor improperly recognized revenues, and failed to provide specific facts that shed light on the mental state of the auditor.

[14] *Haack v. Max Internet Communications, Inc.*, 2002 U.S. Dist. LEXIS 5652 *22-3 (N.D. Tex. April 22, 2002).

pleaded scienter by alleging defendant (1) violated auditing principles and (2) had notes in its accounting file regarding an audit committee meeting which specifically referred to one employee "cooking the books."[15] In *In re Oxford Health Plans, Inc. Securities Litigation*, the Court denied a defendant auditor's motion to dismiss, finding that plaintiff adequately pleaded scienter by alleging GAAP / GAAS violations coupled with "red flags" of which the auditors must have been aware.[16] The red flags included the facts that the client's accounting software could not keep track of accounts receivable, state officials had repeatedly investigated the client, and the company had misstated revenues by "hundreds of millions of dollars."[17] In *In re Health Management, Inc. Securities Litigation*, the Court denied an auditor's motion to dismiss where plaintiff pleaded violations of GAAP / GAAS coupled with red flags of suspicious inventory shipments, and an analyst's letter alerting the auditor to inflated accounts receivables.[18] In *Carley Capital Group v. Deloitte Touche, L.L.P.*, the Court denied an auditor's motion to dismiss, finding plaintiffs adequately pleaded scienter by alleging violations of GAAS coupled with the auditor's unrestricted access to financial records, heavy involvement in management and highly suspicious revenue manipulations that would have "put prudent auditors on notice."[19] In each of those cases, except *Carley*, the auditor, during the period in which improprieties occurred, had knowledge of facts indicating the financial information it was seeing was false, but failed to act upon it. Here, with the possible exception of the "full

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[15] 66 F. Supp. 2d 622, 629-30 (E.D. Pa. 1999).

[16] 51 F. Supp. 2d 290, 295 (S.D.N.Y. 1999).

[17] *Id.*

[18] 930 F. Supp. 192, 202-03 (E.D.N.Y. 1997).

[19] 27 F. Supp. 2d 1324, 1339 (N.D. Ga. 1998).

disclosure" note (see p.5, *supra*), the Complaint merely argues from hindsight that Andersen should have put the facts together to find fraud on the part of the Company. The red flags which courts have alluded to as a basis for finding "severe recklessness" are not pleaded with particularity, nor is the basis for the conclusion of what Andersen "knew" set out in the Complaint.[20] Such deficiencies are fatal under the PSLRA.

Although Plaintiffs refer to the actions or inactions of Andersen as knowing or severely reckless, such statements are merely conclusory. Only as to actions of Andersen after the class period do the Plaintiffs allege that Andersen actually knew of the alleged fraud. Having reviewed the Complaint, the Court is of the view that, except possibly with respect to the auditing note regarding disclosure, what it alleges is negligence. The alleged motive for Plaintiffs' conduct is no more than a desire to make money, and not an extraordinary amount of money for an auditing engagement. Such allegations are insufficient to constitute that level of scienter necessary to satisfy the PSLRA. *See Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994).

Plaintiffs may amend their pleadings in thirty days to establish the scienter which shows that Andersen had the requisite state of mind to support Plaintiffs' allegations. Plaintiffs shall file along with the original and copy of the Complaint a red-lined version showing all changes made to the Complaint. If it wishes to do so, within thirty days thereafter, Defendant may then re-urge a motion to dismiss. Until the amendment is filed and briefing on any new motion to dismiss is complete, this case is **STAYED** for all other purposes.

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[20] *See, e.g.*, p. 25, ¶ 53 of the Complaint, where Plaintiffs allege that "AA was concerned with Intelect's accounts receivable being fraudulent," but states no factual basis for that conclusion.

SO ORDERED this 28 day of January, 2003.

BARBARA M.G. LYNN
UNITED STATES DISTRICT JUDGE
NORTHERN DISTRICT OF TEXAS